AMENDING THE FEDERAL INCOME TAX[1]

By Roy G. Blakey,
Cornell University.

There is every reason to believe that the new federal income tax is to be a permanent part of our fiscal system. Its framers doubtless intended that it should be and the American public apparently has no other expectation. Not only does the experience of other countries confirm this probability of indefinite continuance, but it indicates, also, that this tax will grow in importance with the passing of time. Deep-rooted changes now taking place in American economic and political conditions all point emphatically in the same direction. In fact, in a degree more than most of us seem to realize the relative importance of the income tax seems destined to increase while that of our hitherto most important federal taxes is almost sure to decrease.

In view of the not improbable relative decline of revenues from other sources and of the constantly increasing demands for greater and more varied expenditures and, further, in view of the fiscal possibilities of a wisely-drawn and administered income tax, it is of great importance that we lay broad and firm foundations and that the entire structure be carefully built and tested as we proceed. In order to found thus firmly and build thus carefully, it is well to keep in mind that a *sine qua non* of a good tax is efficient administration, hence everything that seriously interferes with such administration is to be avoided. A corollary of this is that not everything should be attempted at once. What not to do and when to do are almost as important as what to do.

We have now had a year's experience under the new law, a year that has brought forth interpretations both good and bad and one that has shown actual fiscal results. But no one has observed any exultations over these fiscal results. Analyze the figures as one may,

[1] It should be stated that this article was written with the expectation that it would appear in January, 1915. It was prepared in November, 1914, and only the facts available at that date have been included by the author.—The Editor.

conjure up all the allowances that can be imagined as probable, and still one strives in vain to become enthusiastic over the meager receipts from individuals.

But while not being a cause of enthusiasm, our experience to date is far from being a cause of pessimism. It has been too brief and conditions have been too abnormal to attach undue importance to it one way or the other. Other experience has shown that no such tax approximates its maximum yield the first year, and it will be recalled that the first collections in this case covered only five-sixths of a full year. In the cases of many annual, semi-annual, and quarterly receipts, a large part of the income for this ten-months period probably fell due January 1, 1914, or later, and, hence will not be returnable till 1915. Furthermore, it must not be forgotten that the law went into effect within less than a month after its passage, that the larger number of its administrators were necessarily inexperienced, that for individual incomes they had no previous records comparable to the usual records which new assessors find when coming into office, and that they were required to cover a wide diversity of incomes of a great number of individuals scattered throughout a vast expanse of territory.

To note all of these considerations is not to deny that receipts were disappointing nor to claim that administration was perfect. Rather it is to indicate the great possibilities of improving administration and the inexpediency of adding too many refinements and complications before such improvements can be made. Considering the inexperience of our legislators in this field of taxation and the political exigencies under which the law was passed, it is fortunate that Congress produced a measure so generally sound in its fundamental principles and chief provisions. It is not at all surprising that the law contains defects nor that its administration is imperfect.

Proposed amendments of the law may perhaps be grouped into three classes: first, those suggesting substantial alterations in the fundamental principles and main provisions; second, those contemplating changes of secondary importance, for the most part involving applications of the main principles; and, third, those concerned mostly with obscurities, oversights, inconsistencies and other textual defects. It must be admitted that this classification is somewhat arbitrary and that a discussion of one class, especially of the first, involves some discussion of the others; nevertheless, there seem to

be sufficient grounds for making the classification if only to emphasize the differences in importance of proposed changes.

As regards such fundamental matters as definition of taxable income, rates, exemptions and methods of collection, it is our opinion that the law is essentially sound as enacted. All of these matters, especially the method of collection and the exemption of $3,000 (or $4,000), have been vigorously attacked and many amendments have been suggested. Inasmuch as we have discussed these matters elsewhere,[2] especially the latter, brief summary statements may be resorted to here. Although the high exemption makes the income tax somewhat of a class tax, it offsets rather than increases existing inequalities; furthermore, the great difficulties of administration inevitably connected with the inauguration of so inclusive a tax justify minimizing, in the beginning, the number of incomes and the complexities of exemption, deduction and differentiation. This makes the tax applicable to a comparatively small number of incomes which are easiest to assess, most able to pay and most fruitful in yield.

There is little doubt that the question of amending this feature will come up in the near future, probably at the next session of Congress. In fact, this question was considered in connection with the recent bill for making up the deficiency in customs receipts but it was rejected, it was said, because such a change would not bring in funds till June 30, 1915; hence, quicker measures were adopted. The reduction which seems most likely to be adopted is one of $1,000, making the exemption $2,000 for single persons and $3,000 for married couples.

The wisdom of such an amendment depends largely upon the efficiency of administrative machinery and the application of the proceeds. Even after such a reduction, the exemption would be too high to allow the tax to affect directly the great mass of voters, hence such a change would probably not be politically impracticable. Nevertheless, it would arouse a great deal of influential opposition that might better be avoided till the tax is more firmly established in popular opinion.

Considerations of administration would not justify many years of delay in making such a reduction and demands for revenue may

[2] "The Income Tax Exemption," *Outlook*, January 31, 1914. "Income Tax Discrimination and Differentiation," *South Atlantic Quarterly*, July, 1914. "The New Income Tax," *American Economic Review*, March, 1914.

more than counterbalance arguments for any postponement but, unless there are such urgent and legitimate demands, one or two more years under the present law would promote ultimate efficiency. It is probably true that a large proportion of incomes near the margins of exemption are just within, rather than just without, the exemption. Even a reduction of $100 or $200 would probably catch a large proportion of these. The present requirement that all incomes of $3,000 or above be returned (reported), even though many of them are exempt under the $4,000 provision, should furnish records that will be of much service if the exemption is lowered. It would greatly add to the completeness and service of such records to require returns of all incomes down to $2,000 for at least two years before reducing the exemption.

The indications are that, under the present exemption, there are a large number of incomes not correctly reported to which the administrative force should devote a great deal of attention for another year or two and thus clean up this area, so to speak, before adding another much larger and more difficult section to the field. Inasmuch as the distribution of incomes is pyramidal in shape, each lowering of the base causes a vast increase in the number included. There is possibly some truth, though not all of the truth, in the contention that those with small incomes are the worst dodgers of the income tax because those with large fortunes would be too conspicuous marks for the attention of the special agents of the treasury department who are and have been for some time on the lookout for such dodgers. At any rate, the additional incomes included by the suggested reduction in the exemption would greatly increase the difficulty of administration which is yet far from perfect.

What would be the fiscal results of such a reduction? A press report just at hand states that 357,598 individuals made returns for the past year. It is not stated whether this means all returns including those with incomes of $3,000 and above but who do not pay taxes because of the $4,000 exemption, or whether it means taxpayers only. If the latter, each of these individuals would pay an increase of $10 per year with the lower exemption (assuming income to be constant); the maximum tax paid by those newly included would be $10 each, those near the lower limit paying scarcely anything (still assuming incomes the same as before the change). If a reduction of $1,000 in the exemption should include as many addi-

tional incomes as the total number already making returns, there would be a probable increase in receipts of about $6,000,000. Of course, it is a mere guess as to how many additional incomes would actually pay the tax.[3]

When the administrative machinery is in shape to collect the additional amount efficiently, then it will be more equitably secured through such a reduction than through some tariff rates that still remain, but if such additional revenue does not mean a lowering of other taxes, or an application to real needs but merely so much more for the congressional pork barrel, then there is no justification for it. Later on, if the main exemption is put very low, it would be well to make some special exemptions for children in certain cases, and possibly also, for insurance payments and other causes of expenditure which it may be thought best to encourage.

In any case, there is a textual ambiguity in the paragraph of the statute which provides for the $3,000 (or $4,000) exemption about which there is no doubt as to the desirability of amendment. As it is, it is uncertain whether a married couple should have a possible total exemption of $4,000 or $7,000; that is, whether, individual income or family income should be taken as the basis of computation. The ruling of the commissioner of internal revenue is that family income is to be taken as the basis of the normal tax, but individual income as the basis of the additional tax. This is admittedly inconsistent. Even the administrative officers have advised clearing up this difficulty.

Many of the principles applicable to the proposals for amending the exemption are also applicable to those relative to changing the rates. It cannot be proved *a priori*, nor from the brief experience of a year, that the existing rates, or any other more or less arbitrary set that might be adopted, form the best possible schedule. But other experience has proved that low rates cause much less fraud and evasion than high rates and there could be no surer way of destroying the usefulness of the tax than to make rates high before the administrators have secured rather complete and accurate information as to the taxable incomes in the United States. Such information should be secured as rapidly as possible and, after that is done, there would

[3] Later press reports showing distributions of 1914 tax returns indicate great uncertainty as to number of new incomes that the suggested return would include.

be an excellent opportunity to make the income tax an equalizer of receipts and expenditures, merely by adjusting the rates from year to year. That is, this would be the case if such a proposal did not imply a budgetary control that seems impossible under our form of government. As it is, there is always the danger that increased revenue possibilities mean increased government extravagances.

As to the method of collection, it is probable that there will be some attempts to substitute information-at-the-source for collection-at-the-source, that is, corporations and other sources, instead of withholding the tax, will inform the government officials of the amount of income paid by them to various individuals. In so far as the recipients of such incomes can be easily located within the United States, such a substitute might be entirely feasible. It would lessen the burden now thrown upon withholding sources and would not deprive the taxpayer of the use of his money for so long a time. Furthermore, it would not throw upon him the risk of solvency of his debtor source from the time the tax is withheld until it is turned over to the government, sometimes a matter of more than a year and in most cases several months. Such a method could not be applied in cases of unregistered bonds and interest coupons nor in other cases where the recipients were without the jurisdiction of the United States. It would probably mean a somewhat greater expense to the government and also some additional evasion and loss. Its adoption seems of somewhat doubtful expediency, though in case of great demand for it, a trial that would be distinctly understood as tentative might be given for a year or two. This would imply more experience with the present method than we have so far had, in order to have a basis for comparison of results.

In this connection, it should be mentioned that many of the forms used in connection with statements of ownership, claims for exemption and returns of income have already been revised, and it is claimed that the burden thrown upon taxpayers and withholding agents will be very much less than heretofore. Furthermore, there is some probability that withholding agents will be allowed a certain compensation for the burdens of collection, say, one per cent of what they collect. This might not be more than fair, though just what differentiations should be made in cases of corporations is not easily determinable. It may be recalled that our tax, as it is, allows corporations to deduct interest on bonds which is not the case in many other countries.

There are two differentiations against corporate incomes under the present law that do not seem wise in all cases, first, the differentiation against the small owners of corporate stock to whose dividends the exemption is not allowed to apply and, secondly, the multiple taxation of holding company receipts. The first involves not only differential treatment of corporate incomes and discouragement to small investors therein but, in practice, it also involves differential treatment of individuals. The second assumes holding companies to be bad *per se*. It is to be admitted that such companies have a good many sins to account for, but the hearings on the recent anti-trust bills and other facts establish a strong presumption in favor of holding companies in some cases. It is entirely probable that Congress will make some modifications as regards railroads and other public service corporations.[4]

English, Prussian and other income-tax laws provide for a differentiation between earned and unearned or funded incomes, laying heavier rates upon the latter. We should adopt this principle soon, but administrative considerations are against adding this additional complication for a year or two. As a matter of fact, we already have a large degree of such differentiation because most funded incomes in this country arise from corporate sources and real estate. Besides the differentiation of the income tax against the former, there is a similar and growing tendency in state and local taxation and it is notorious that a heavier burden has been piled upon real estate with the breaking down of the general property tax. The other large sources of funded incomes are government bonds. A large proportion of federal bonds are held by national banks and as regards these and all others, additional taxes upon their interest would be reflected in higher rates or lower prices for the issuing governments.

Roughly speaking, the law's conception of taxable income in-

[4] The writer cannot wholly agree with the statement of Professor Seligman (*Income Tax*, 2nd ed., p. 695) that requiring corporations to pay the tax on interest of bonds which they had sold under guarantee that buyers would be free from such a tax mulcts the wrong person, that is, the corporation or its stockholders, instead of the bondholders. If that were entirely true, there would have been no point in guaranteeing the bonds to be tax-free. In paying the tax, the corporations or their stockholders are merely paying what they contracted to pay, if necessary, in consideration of a higher price for bonds. No doubt they hoped the lightning would not strike, or that the time should be long delayed, but everybody had seen plenty of warning flashes.

cludes only monetary receipts, those from personal exertions and net gains from capital. Gifts and non-monetary income are excluded. For example, the law disregards home-consumed produce of the farmer or rental value of a residence occupied by the owner, though produce sold for cash or rent actually received or paid in cash are required to be accounted for in income-tax returns. In most cases it is probably most practicable to confine returns to monetary incomes and to those easily and fairly accurately convertible into money equivalents, otherwise it would lead to the impossible task of estimating the money value of all pyschic incomes. It does seem, however, that the rental value of residences is one of the forms of non-monetary income that it would be practicable and desirable to include, though such an amendment to the rulings might well be postponed a year or two for the same reasons that have been mentioned in connection with other refinements.

The ambiguities in the statute relative to insurance companies seem to have been straightened out fairly well in the rulings. The net result now appears to be that the companies will have to pay an income tax on only the excess of premiums over expenses of carrying on the business and payments on policy contracts, plus a tax on interest received on such excess. This means practically no taxation upon capital as opposed to income, and the tax will be even less in some cases by virtue of the exemption of legally required reserves. No amendment seems desirable in this case unless it would be to put in the form of statute what now rests upon rulings. This is of doubtful expediency.

The statute is indefinite and the rulings are inconsistent, as well as unsound in some cases, as to the treatment of appreciation and depreciation of capital assets. The statute requires the inclusion of all income and provides for deduction of losses incurred in trade or arising from fire, storms or shipwreck. Some rulings hold that corporations may adjust the book values of their securities from year to year and return income accordingly. Others hold that all fluctuations in capital assets, whether of corporations or individuals, at least so far as losses are concerned, are not to be considered in returns, unless the results of actual sales, closed transactions. Furthermore, one ruling holds that losses from sales of real estate cannot be deducted unless incurred "in trade," that is in "business," and, that a single transaction does not constitute the carrying on of a business.

Another ruling holds that increases in value of real estate are to be prorated equally among all the years owned and that the part thus apportioned to the years since the tax has been in force is to be returned as the income of the year of sale. The ruling appears to be especially for corporations and will be fair enough for them since they have no yearly exemption and pay no additional tax. But for individuals, it will be important whether such gains are lumped into one year's return or distributed over several years. The problem is undoubtedly a difficult one from a practical standpoint but the present status is susceptible of considerable improvement.

There is considerable weight in the arguments against the injustice of the double taxation involved in taxing all citizens whether residing at home or abroad and also all residents whether citizens or not. Perhaps the easiest way, if all nations would agree to it, would be to tax according to the situs of the source of the income, though a resident undoubtedly receives many benefits from the government where he lives and owes it some duties, even though all sources of his income may be located in other jurisdictions. He also owes some duties to his home government and may put it to great expense as the present European war has forcibly demonstrated in case of our absentee citizens.[5] An equitable distribution of taxes in such cases is one of the unsolved problems of taxation.

The rulings of the commissioner of internal revenue permit nonresident aliens to escape taxes on interest and dividends of domestic corporation securities. The ruling as to dividends is ambiguous, though it probably means that the foreign holder of domestic stocks shall not pay a tax in addition to the one paid by the corporation. As to bonds, the ruling is of doubtful constitutionality, as the legal situation is anomalous. As to both bonds and stocks, the ruling is economically unsound if situs of the tangible source of income is to hold, and it is certainly inconsistent with some provisions of the statute as well as with some of the rulings of the commissioner. Such exemptions have the justification that they attract the investment of foreign capital. They thus discriminate in favor of foreign investors

[5] Incidentally, the European war has been of great aid to income tax officials in ascertaining the names, location and status of citizenship of many Americans abroad. Passports have been applied for as never before, so that present records of Americans abroad are unusually good. Perhaps the number who would have claimed expatriation has been considerably reduced.

and certain domestic corporations, just as do certain laws and winkings of various states and localities within the United States in order to attract capital. This is one of the most insidious and irresistible methods of making local taxation ineffective and is one of the most powerful sources tending toward centralized as opposed to local self-government.

As to desirable textual amendments, as well as some minor matters of principle, we have seen no suggestions so comprehensive and worthy of consideration as those in the recent report of the American Bar Association's Committee on Taxation. We will mention only a few of the criticisms which are well taken. The arrangement of the provisions of the statute is haphazard, references are unnecessarily difficult to make and the lack of system can only be remedied by an entire recasting of the act. Various terms or phrases are ambiguous or are used with several different meanings in different parts of the statute, for example, "deductions," "exemptions," "arising or accruing." Certain enumerations in the law are either more restrictive than intended, or than they should be, especially in view of the fact that they have been interpreted strictly. This applies particularly to the losses and exemptions allowed. For example, the exempting enumeration names mutual building and loan associations, savings banks and other organizations but says nothing of mutual insurance, telephone and many other similar undertakings which it would seem should be classed with those enumerated. The provisions for penalties are incongruous; they consist of one set for the new income tax plus the old set for excise taxes clapped on without much thought of adjustment between the two sets. Many Americans abroad have no place of business in the United States, hence no designated collector to whom to report their incomes. Appeals to the commissioner of internal revenue are provided for in case of grievances; local hearings should be provided for also. The provisions regarding fiduciaries should be modified and gifts of annuities, now seemingly exempt, might properly be classed as income. A number of other criticisms have already been considered above.

To summarize, it may be said that the income tax is sound in its fundamental principles and that only such amendments should be made at present as will not add greatly to administrative difficulties. The administrative force should use all of its endeavors to secure accurate and complete returns for those now legally liable

to the tax before adding a vast number of new incomes by lowering the exemption. Meanwhile those with smaller incomes, say down to $2,000, should be required to make returns (reports) and, in another year or two, the exemption should be lowered. A year or two later differentiation between earned and unearned incomes might be adopted and information-at-the-source given a test as regards certain kinds of income. By that time, or a little later, experience and revenue necessities may indicate desirable changes in the rates of the tax.

That is, there is one class of amendments that should be made in due time, but that time is a little later rather than now. As regards secondary matters involving applications of the law, as for example, what should be included as income, what should be the basis of income exemptions, how should increases in capital value, and other similar matters be treated, the sooner the statute or the rulings are amended properly the better. The same is true of the third class involving textual defects in the statute.

If administration is properly safeguarded and perfected and the tax made as successful as it may be, it is likely to have a great influence upon state and local taxation. It does not seem probable, however, that we shall soon adopt the suggestion to distribute a substantial part of the proceeds among the states, though such a move would probably be wise later if the tax is made as efficient as it may be. One very desirable thing that should not require an amendment is the publishing of detailed statistics of returns. The more accurate these are, the lower the exemptions, and the more differentiations and graduations there are, the more valuable such statistics should be. They should be very useful for the light they would throw upon many problems of modern social legislation, as well as for other economic and political considerations.

The fundamental changes in our economic situation, the ability of our manufacturers to meet foreign competition in the home market and the growing attention to the foreign market, are sure to diminish the relative importance of the protective tariff as a revenue producer, and, in fact, the movement has already begun, though its growth will be gradual rather than sudden. This is certain to bring the income tax into greater prominence. Still further, it is not beyond the pale of possibility that the efficiency propaganda, the prohibition propaganda and other allied and deep-rooted forces are going

to do away with the liquor traffic in the United States sooner than most of us believe. This would do away with the other great source of federal revenues and still further magnify the rôle of the income tax.

In view of our probable needs and of the ability of a good income tax to meet them, perhaps more equitably and adequately than any other important tax which can be used by the federal government, it is extremely important that we lay good foundations and it can not be repeated too often or emphasized too strongly that all considerations of amendments should recognize that efficient administration is the great desideratum.